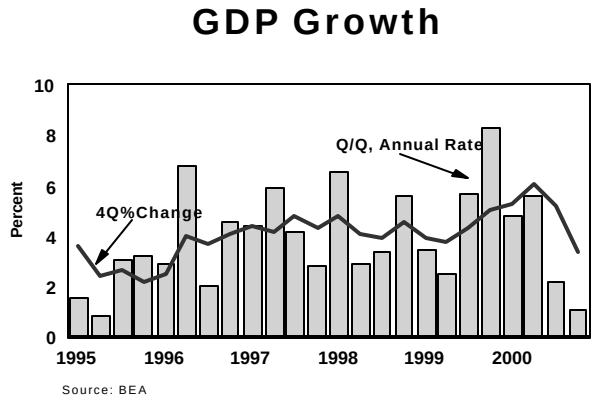
MARCH 2001

US OVERVIEW

The economy slowed substantially in the second half of 2000 spurring an abrupt reduction in short-term interest rates by the Federal Reserve and expectations of further rate cuts to come. The two key questions going forward are whether the economy will avoid a recession and how soon (and whether) it will return to the robust growth of the past several years.

The Slowdown Has Arrived

In the five years ending in the second quarter of 2000 the economy grew at a 4.4 percent annual rate. The economy had not grown that fast for any five-year period since 1983-88. Growth peaked at 6.1 percent in the four quarters ending Q2.2000. Remarkably, such fast growth occurred more than eight years after the end of the last recession. Usually, growth is highest near the beginning of a recovery, not deep into an expansion.



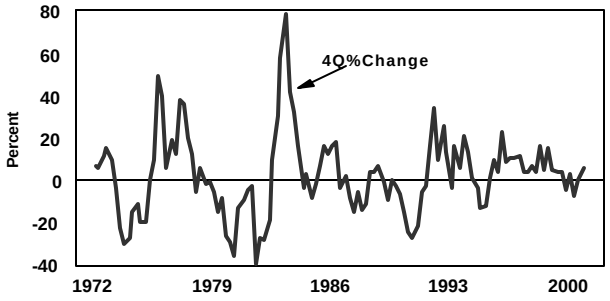
Since Q2 growth has stalled, coming in at a 2.2 percent rate in Q3 and a 1.1 percent rate in Q4, the slowest two consecutive quarters since the first half of 1995. The slowdown has been attributed to higher energy costs, the tightening of monetary policy in 1999-2000, less access to credit for relatively risky businesses, and a wide fluctuation in long term interest rates from 1998 to 2000 that shifted some of the activity that would have occurred in late 2000 and early 2001 into 1999 and early 2000.

Recession or Not?

In predicting the outlook for future growth, economists are divided into three camps. Some forecast a "V" shaped pattern for growth in which Q1.2001 is the slowest quarter and the economy returns to 3 percent growth or more by the second half of the year. Others forecast a "U" shaped pattern, in which growth bottoms out for three quarters or more in either very low positive territory or negative territory. A smaller group forecasts a gloomy "L" shaped pattern in which the US suffers at least a miniature version of the depressed economic conditions Japan has suffered since the early 1990s.

Most economists agree that, recession or not, business investment will be weak in 2001. Business investment is, in part, determined by corporate profits and corporate profits are under pressure as production costs rise faster than prices for final goods and services. Unit labor costs are a key measures of production costs. By factoring in both labor compensation *and* productivity, unit labor costs tell us how much businesses are paying workers to produce a given level of output. For example, a 5 percent increase in worker pay and a 5 percent increase in worker productivity means unit labor costs remain the same. In the second half of 2000, unit labor costs rose 3.7 percent, the fastest two-quarter pace since early 1993. Worse, unit labor costs grew faster than the core consumer price index by the largest margin since the late 1980s. A squeeze on corporate profits need not stop investment if credit is plentiful, but weakness in the stock market, high interest rates on high-yield bonds, and tougher lending standards at financial institutions mean equity and debt financing will not make it easy for most firms to raise external funds to invest during the period of weak profits.

New Home Sales

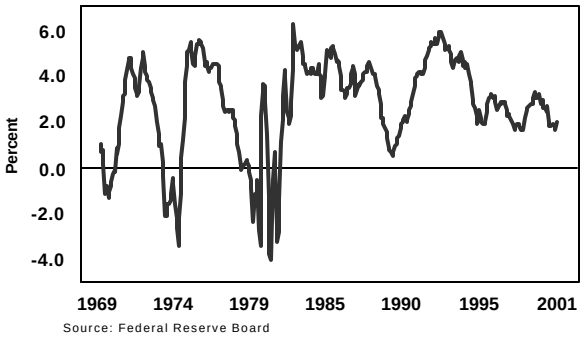


Source: Census

Despite the likely weakness in business investment, the usual indicators that in the past have signaled recessions have yet to make an appearance. These past indicators have included a steep drop in new home sales, short-term interest rates higher than rates on long-term corporate bonds, and a spike in core consumer prices.

New homes sales have dropped steeply either right before or right at the start of every recession since the early 1970s. At present, there's no sign of a steep drop in the market for new homes. In fact, sales in Q4.2000 hit a record high. Nor are new homes sales likely to plummet anytime soon. Mortgage rates have dropped 1.5 percentage points since May 2000 and would drop further if the slowdown intensified in other sectors. The one case where new home sales dropped significantly only after the recession had started was in 1981-82. Right before that recession mortgage rates had spiraled upward – certainly not the case today.

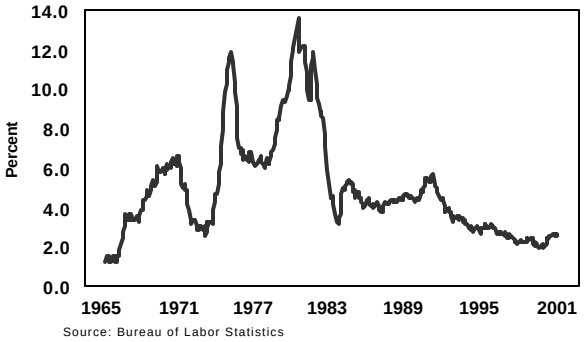
Corporate - Fed Funds Yield Gap



Source: Federal Reserve Board

Yield comparisons also suggest the economy will avoid recession. Since the early 1970s a recession has always been preceded by a steep decline in the difference between the yields on Baa-rated corporate bonds and the federal funds rate. Usually, a recession has been preceded by an inversion of this yield gap, in which the overnight interest rate controlled by the Federal Reserve exceeds the interest rate many companies have to pay to borrow long term. At present, we have not experienced an inverted yield gap or even a sharp decline in the yield gap of the kind we had before the 1990-91 recession.

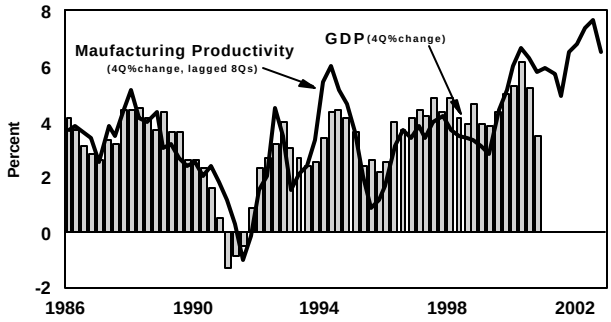
Core Consumer Prices



Source: Bureau of Labor Statistics

Why is this indicator so important? Because it reveals the extent to which the Federal Reserve believes the economy has developed imbalances that could lead to inflation. An inversion of the yield gap normally results from a steep increase in interest rates by the Federal Reserve as it seeks to stamp out inflation pressure. If there is little inflation pressure to offset, less monetary tightening is required, the yield gap is less likely to invert, and monetary contraction will contribute much less to the slowdown.

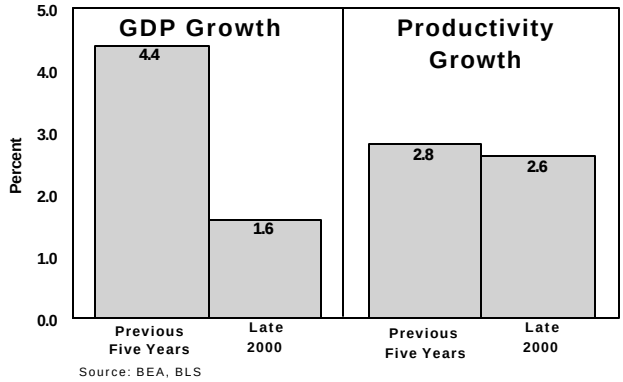
GDP and Manufactring Productivity



Source: BLS, BEA

A spike upward in core inflation itself is also a leading sign of a recession. The recessions of 1970, 1973-75, 1980, 1981-82, and 1990-91 were preceded by core consumer inflation rates of 6 percent, 4.7 percent, 11.3 percent, 13.1 percent and 5 percent, respectively. By contrast, despite a spike in energy prices, the highest core inflation in the past year has been 2.6 percent. Core prices omit the *direct* effect of food and energy prices, but show their effects indirectly if those price increases seep through to those other sectors.

Productivity Stays Strong



Source: BEA, BLS

In addition, productivity trends bode well for future economic growth. Since 1986 there has been a strong relationship between manufacturing productivity growth and GDP growth two years later. Remarkably, manufacturing productivity has predicted every major turn in the business cycle since the mid-1980s, including the non-recession slowdowns of 1986, 1993 and 1995. Most recently, it predicted a peak in the economic growth rate in Q2.2000 (which turned out to be correct) and a near-term bottom for the growth rate in Q3.2001. Thereafter, the economic growth rate should quickly recover if this relationship continues to hold. The caveat is that the relationship may weaken as manufacturing becomes a smaller share of GDP.

Finally, another positive sign regarding productivity is that even as economic growth slowed to 1.6 percent in the second half of 2001, non-farm productivity grew at a 2.6

percent rate.[1] That is only marginally less than the 2.8 percent productivity trend during the previous five years, when overall economic growth was a lofty 4.4 percent. Typically, productivity growth increases when the economy is strong and declines when the economy is weak, as businesses work harder to get more output per worker per hour when the economy is pushing against the limits of its capacity. The portion of productivity growth that depends on the strength of the overall economy is *cyclical*. The portion of productivity that is *not* subject to the ups and downs of the business cycle is *structural*. Because the cyclical contribution to productivity growth depends on where we are in the business cycle it lacks information about the long term trend. By contrast, high structural productivity growth indicates a strong long term trend for economic growth, as productivity growth plus growth in hours worked approximates overall economic growth.

Key Economic Indicators

Quarterly Indicators

(Q/Q, at annual rate)

	Q1-00	Q2-00	Q3-00	Q4-00
Real GDP Growth	4.8	5.6	2.2	1.1
Consumption	7.6	3.1	4.5	2.8
Business Investment	20.6	17.9	5.6	-0.6
Trade Deficit ($ bilions)	85.3	88.8	95.8	99.7
PCE Inflation	3.5	2.1	1.8	1.9
Productivity Growth	2.1	6.3	2.7	2.4

Monthly Indicators

	Nov.	Dec.	Jan.
Unemployment	4.0	4.0	4.2
Payroll Growth	53K	19K	268K
CPI Inflation (yr./yr.)	3.4	3.4	3.7
Retail Sales Growth (yr./yr.)	5.0	3.3	3.5
Corporate Rates (Baa)	8.3	8.1	7.9
Federal Funds Rate (Month End)	6.5	6.5	5.5
Dow (Month End)	10707	10637	10664

[1] Productivity for the fourth quarter of 2000 is expected to have been revised down, although only slightly, by the time you read this Bulletin.